

UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON, D.C. 20301-1100

NOVEMBER 19, 1998

MEMORANDUM FOR:

UNDER SECRETARY OF DEFENSE (ACQUISITION AND TECHNOLOGY)
UNDER SECRETARY OF DEFENSE (PERSONNEL AND READINESS)
ASSISTANT SECRETARY OF DEFENSE (HEALTH AFFAIRS)
DIRECTOR, ADMINISTRATION AND MANAGEMENT
DIRECTORS OF THE DEFENSE AGENCIES
UNDER SECRETARIES OF THE MILITARY DEPARTMENTS

SUBJECT: Department of Defense Implementation Strategy for Auditable Financial Statements

On November 10, 1998, the Department provided the Office Management and Budget (OMB), the General Accounting Office and the Office of the Inspector General, Department of Defense finalized copies of four more implementation strategy issue papers for achieving unqualified opinions on the Department's financial statements. Four strategy papers (Attachment 1) have been approved, and now, we must implement these strategies. Accordingly, please begin implementing the actions for which your organization is responsible.

To date, ten implementation strategy issue papers have been approved. Copies of the initial six issue papers that were approved on October 6, 1998 are at attachment 2. The remaining three issue papers of the Department's proposed "first round" implementation strategy remain unresolved. Efforts continue to address these remaining issues.

As you are aware, the OMB has directed each federal agency to provide periodic reports on the status of its actions. To monitor the Department's progress, as well as to meet the OMB reporting requirement, periodic status reports will be required on all of the approved strategy papers. It is my intention to keep the workload associated with the reporting requirements to a minimum. Specific reporting requirements are being provided separately.

My staff contact on this matter is Ms. Brenda Goodridge. She may be reached by e-mail: goodridb@osd.pentagon.mil or by telephone at (703) 697-3192.

(Signature, Alice C. Maroni)
Alice C. Maroni,
Principal Deputy Under Secretary of Defense (Comptroller)

Attachments

cc:

OMB

GAO

IG, DOD

A.1. GENERAL PROPERTY, PLANT AND EQUIPMENT EXISTENCE & COMPLETENESS (Excludes Property in the Hands of Contractors)

Proposed Department of Defense

- The Department proposes to require that, when military units conduct periodic inventories of property, plant and equipment (PP&E) throughout the year, a step will be mandated that requires verification of the property accountability records and/or systems to ensure that all property, plant and equipment is properly recorded.
- The Under Secretary of Defense (Acquisition and Technology) will issue a memorandum emphasizing the need for (1) complying with existing policies relative to PP&E accountability and (2) ensuring that property records are up-to-date and accurate.
- The Under Secretary of Defense (Acquisition and Technology) will direct the DoD Components to reconcile the data fields of their installation-level PP&E databases with their headquarters and/or centralized databases to ensure consistency, completeness and reliability of data.
- The Under Secretary of Defense (Acquisition and Technology) will review PP&E data base reconciliation requirements to ensure that they include a requirement to reconcile installation, headquarters and centralized data bases, at least semi-annually, including yearend; as well as make appropriate adjustments.
- The Military Departments will ensure that reconciliations among installation, headquarters and centralized databases, are conducted at least semi-annually, including yearend; as well as make appropriate adjustments.
- The DoD Components will ensure that they have procedures in place to remove the costs of completed PP&E from construction-in-progress accounts, and that General PP&E costs are capitalized and depreciated, as appropriate.
- The DoD Components will ensure that all PP&E that meets the criteria for capital leases, as described in SFFAS No.6, are properly recorded and reported.

A.3. PROPERTY, PLANT AND EQUIPMENT GOVERNMENT PROPERTY IN THE HANDS OF CONTRACTORS

Proposed Department of Defense Actions

The Department will:

- Continue to require contractors to report government property in their possession on a fiscal year basis.
- Ensure that contractors that have or had government property in their possession during the reporting period submit a property report for each contract under which the government property is or was accountable.
- The Department will value property purchased or produced by a contractor for the performance of cost reimbursement contracts in accordance with the contractor's disclosed accounting practices, the cost principles in Federal Acquisition Regulation (FAR) Part 31 and, when applicable, the Government's Cost Accounting Standards. Reporting entities shall be required to document the valuation methodology when reporting the acquisition cost of property acquired or produced by a contractor at a value that is not supported by the contractor's cost or property records.
- Use the property records required by the FAR as the source data for physical accountability and financial management reporting.
- Ensure that property reports are structured to provide the information needed for compliance with requirements of federal-wide accounting standards.
- Require contractors to enter into their property records the acquisition date and cost of each contractor acquired general property, plant and equipment item that is government property in the contractor's possession (estimated acquisition dates and cost may be used when the actual acquisition date is not known).
- For government furnished property, provide to contractors acquisition dates (or a reasonable estimate thereof when an actual date is not known) to be entered into the property record.
- Require contractors to extract and report data from their property records in a standard format that will permit the calculations of depreciation that will satisfy requirements of federal-wide accounting standards.
- Develop a plan to validate the adequacy of the contractor's property management systems and the accuracy of the data in those systems and work with the contractors to properly implement the plan.

Proposed Milestones and Responsible Officials

1. November 1998: USD(A&T) to issue a memorandum to the Military Departments and Defense Agencies requiring that when inventories of military equipment and other property, plant and equipment are conducted, such inspections and inventories include a requirement to validate the existence and completeness of property accountability records and systems. The methodology to validate the existence of General PP&E will include a test of assets to the supporting records. Additionally, the methodology to validate completeness of General PP&E will include a test of the supporting records to the assets on hand.
2. November 1998: USD(A&T) to issue a memorandum to the Military Departments and Defense Agencies emphasizing the need for complying with existing policies for PP&E accountability and for ensuring that property records are up-to-date and accurate.
3. November 1998: USD(A&T) to issue a memorandum requiring the DoD Components to reconcile the data fields of their installation-level PP&E data bases with their headquarters and centralized data bases to ensure consistency, completeness and reliability of data.
4. November 1998 - April 1999: USD(A&T) to issue property accountability regulations.
5. November 1998 - January 1999: USD(A&T) to review PP&E data base reconciliation requirements currently in place to ensure that they are appropriate, adhered KO and include periodic and fiscal year-end reconciliations between installation and headquarters and centralized data bases and to update such requirements as necessary.
6. November 1998 - September 1999: Under Secretaries of the Military Departments and Directors of Defense Agencies to ensure that periodic and fiscal year-end reconciliations between subsidiary installation and headquarters and centralized data bases are conducted periodically and at year-end.
7. November 1998 - January 1999: Under Secretaries of the Military Departments and Directors of Defense Agencies to take appropriate actions to ensure that procedures are in place to remove the costs of completed PP&E from construction-in-progress accounts, and that such PP&E costs are capitalized and depreciated, as appropriate.
8. November 1998 - January 1999: Under Secretaries of the Military Departments and Directors of Defense Agencies to take appropriate actions to ensure that all PP&E that meets the criteria for capital leases as described in SFFAS No. 6, properly are recorded and reported.
9. November 1998 - September 1999: Under Secretaries of the Military Departments and Directors of Defense Agencies to take appropriate actions to ensure the accuracy of data in their property accountability systems.
 - Concentrate initially on those contractors that possess the largest portions of government property in the hands of contractors.

NOTE: Some of the actions discussed above affect the public. Section 22 of the Office of Federal Procurement Policy Act requires the Department to obtain and analyze public comments prior to implementing the actions. That is a lengthy process which, when coupled with the thousands of contracts that might need to be modified, makes it highly unlikely that all such contracts could be modified prior to September 30, 1999. The Department will investigate the possibility of making blanket modifications to contracts through such vehicles as the Single Process Initiative.

Proposed Milestones and Responsible Officials

1. August 1998 - December 1998: USD(C) and USD(A&T) to develop new contractor reporting format/requirements needed to meet financial statement standards.
2. December 1998 - June 1999: USD(A&T) to take appropriate actions to modify the DFARS to implement new reporting format/requirement.
3. December 1998 - March 1999: USD(A&T) to develop, and share with OMB and auditors, a plan to validate the adequacy of the contractor's property management systems and the accuracy of the data in those systems and work with the contractors to properly implement the plan.
4. March 1999 - September 1999: USD(A&T) to direct the Military Departments and Defense Agencies to work with, as appropriate, the Defense Contract Management Command with support from the Defense Contract Audit Agency, Service auditors, Inspector General auditors, and applicable contractors to validate the adequacy of the contractors' systems and accuracy of the information reported.
5. March 1999 - September 1999: Under Secretaries of the Military Departments and Directors of Defense Agencies to take appropriate action to ensure that new contracts are written and existing contracts are modified to require contractors to meet new reporting format/requirements. The Department will concentrate on those contracts that possess the largest portions of government property in the hands of contractors.
6. June 1999 - July 1999: Upon request from the OUSD(A&T), OMB provide emergency approval of the Department's paperwork burden analysis and approval to publish the revised DFARS rule within 5 workdays of submission by the DoD.
7. July 1999 - December 1999: Under Secretaries of the Military Departments and Directors of Defense Agencies to ensure that their personnel work with, as appropriate, the Defense Contract Management Command with support from the Defense Contract Audit Agency, Service auditors, IG auditors, and applicable contractors to validate the adequacy of the I contractors systems and the accuracy of the information to be reported. The Department will concentrate on those contracts that possess the largest portions of government property in the hands of contractors.
8. July 1999 - August 1999: If it is determined that blanket modifications to contracts through the Single Process Initiative are feasible, USD(A&T) to take appropriate actions to ensure that such blanket modifications are written and implemented.
9. October 1999: Contractors to begin reporting required information using the new format. In addition, contractors may be asked LO submit a one-time report that provides required data (costs, acquisition dates, useful lives, and related depreciation information) necessary to comply with the new accounting standards for General PP&E.

B.1. INVENTORY ISSUES

EXISTENCE, COMPLETENESS AND VALUATION OF INVENTORY

Proposed Department of Defense Actions

- The USD(A&T) will direct the Military Departments and the Defense Logistics Agency to evaluate inventory transaction processing (issues and receipts), identify errors, determine the sources and causes of errors, and develop a remedial plan to correct those errors and the need for routine manual adjustments.
- To improve controls over physical inventories the OUSD(A&T) and DoD Components will:
 - a. Establish procedures for how counts should be organized and performed at depots and installations.
 - b. Determine the minimum acceptable error rates for physical inventory measurements.
 - c. Ensure those personnel that perform physical inventory counts do not have physical control over the inventory.
 - d. Reconcile physical counts to records promptly and correctly. For example, reconciliations of physical counts to records should also include consideration of activity such as inventory receipts and issues that took place during or after the physical count.
 - e. Utilize an independent office within the entity for which a physical inventory was taken (e.g., internal audit, accountable officer, or quality assurance personnel) to ensure that record adjustments are in compliance with regulations and established business practices for physical inventory and that adjustments exceeding established criteria are researched to identify causes and implement corrections.
- The OUSD(A&T) and DoD Components will establish a physical inventory plan that integrates cycle counts and statistical sampling with the full participation of the OUSD (Comptroller) and the audit community.
 - a. Design and implement a sampling methodology that will meet both the requirements of federal-wide accounting standards and the Department's requirement to validate the accuracy of property accountability records.
 - b. Implement procedures and management controls to ensure the physical inventory plan is achieved.
 - c. Notify auditors of proposed physical inventory methodologies and implementation schedules in advance.
 - d. Implement risk-based physical inventory measures that demonstrate a greater concern for sensitive items, high dollar items, and less concern for low dollar, high volume items. Policies will establish the minimum acceptable error rates that should show little to no tolerance for sensitive and high dollar items. The measures should provide confidence that errors are immaterial or that they are being reduced to an acceptable level in the aggregate.

- e. Conduct a 100 percent physical inventory annually for inventory categorized as Sensitive or Classified by the Controlled Inventory Item Code.
- To improve intransit inventory accounting, the Military Departments and Defense Logistics Agency will improve procedures and monitor their implementation to ensure that receipts and issues are timely and properly posted to appropriate records and that system improvements/enhancements are made as necessary to improve accountability/visibility over intransit inventory.
 - The Department intends to continue the use of formulas to approximate historical/latest acquisition cost for the Department's inventory for inventory that is controlled through systems that do not report inventory at historical costs.
 - The Department will continue to refine current formulas in conjunction with the Military Departments and the audit community.
 - The Comptroller, audit community and OMB will work towards a consensus on the accounting treatment of inventory gain and loss accounts.
 - The OUSD(A&T), OUSD(C), Military Departments, and audit community will work towards a consensus on the logistics and accounting treatment and valuation of &pot level repairable inventory; and the revenue reporting practices associated with receipts and issues of repairable items.
 - The Department will work with the OMB and the audit community to identify the approximate historical cost for the beginning balance of inventory.

Proposed Milestones and Responsible Officials

1. December 1998: The USD(A&T) will direct the Military Departments and the Defense Logistics Agency to evaluate inventory transaction processing (issues and receipts), identify errors, determine the sources and causes of errors, and develop a remedial plan to correct those errors and the need for routine manual adjustments.
2. December 1998 - September 1999: The DoD Components shall conduct physical inventory counts as prescribed by Chapter 7, DoD 4000.25-2-M(MILSTRAP), and as further directed by the OUSD(A&T). Each DoD Component shall provide advance notice of its physical inventory schedule to its applicable audit organization.
3. December 1998 - September 1999: The Military Departments and Defense Logistics Agency will improve procedures and monitor their implementation to ensure that inventory receipts and issues are timely and properly posted to appropriate records and that visibility over intransit inventory is improved through system improvements and/or enhancements.
4. October 1998 - September 1999: The USD(C), along with the audit community and DFAS, continue to refine inventory valuation formulas and work towards a consensus on the accounting treatment of inventory gain and loss accounts.
5. November 1998 - March 1999: The USD(A&T) and USD(C), along with the Military Departments and audit community, to work towards a consensus on the logistic and

accounting treatment and valuation of depot level reparable inventory; and the revenue reporting practices associated with receipts and issues of reparable items.

6. December 1998: The USD(C) and the DFAS to work with the Under Secretaries of the Military Departments, the Director of the Defense Logistics and the audit community to implement acceptable methodology that will approximate historical/latest acquisition cost for the Department's inventory. Acceptable methodology should be developed by June 1999.

C3. LIABILITIES ISSUES POSTRETIREMENTHEALTH CARE LIABILITIES

Proposed Department of Defense Actions

- The Department will revise its procedures to ensure that all data used in calculating the liability are current.
- The Department will take the impact of the TRICARE program into account in estimating the liability and will ensure the information TRICARE providers collect meets DoD Actuary requirements.
- The Department will make all substantive financial statement disclosures required by SFFAS No.5.
- The Department Will work with the General Accounting Office (GAO) and the Inspector General, DoD, to ensure that a sound methodology is used by the DoD Actuary KO calculate the FY 1999 liability, The Department will document how CHAMPUS weightings were developed and ensure that the CHAMPUS Diagnosis Related Group (DRG) weights are updated annually with the most recent data available.
- The Department will assess the feasibility of using Medical Expense Performance System (MEPRS) cost data for calculating Military Treatment Facility casts. This analysis will investigate whether the liability calculation should be based on the most reliable data, e.g., budgetary data (current methodology) or the cost data from MEPRS. Based on the results of the analysis, the liability calculation. Will use the most accurate and reliable source for cost information.
- The Department will review its procedures to ensure that reasonably accurate, reliable, timely, and complete data required for estimating the liability is captured and reported. The Department will review its current procedures to standardize business practices, establish and strengthen management controls and develop monitoring and audit procedures for the relevant data systems.
- The Department will conduct a sensitivity analysis to determine the extent to which the identify sensitive to cost data, demographic data, and economic assumptions. The results will be used to set priorities to develop a better estimate.

Proposed Milestones and Responsible Officials

1. November - December 1998: USD(P&R) to ensure that the Office of the DoD Actuary oversees the collection of complete and current health benefit claims, participant, and other relevant dam for use in determining the FY 1998 Military Retirement Health Benefits liability.
2. January - February 1999: USD(P&R) to ensure that the Office of the DoD Actuary rakes the impact of TRICARE into account in determining the FY 1998 and subsequent year Military Health Benefits liabilities.
3. January - February 1999: USD(P&R) to ensure that the Office of the DoD Actuary, with assistance from the Defense Finance and Accounting Service, makes all substantive financial

statement disclosures beginning with the FY 1998 financial statements.

4. December 1998 - September 1999: USD(P&R) to work with the General Accounting Office (GAO) and the Inspector General, DoD, to ensure that a sound methodology is used by the DoD Actuary to calculate the FY 1999 liability.
5. March - April 1999: USD(P&R) to ensure that the Office of the Assistant Secretary of Defense (Health Affairs) documents the development of CHAMPUS weights and ensures that the weights are updated with the most recent data available.
6. December 1998 - September 1999: USD(P&R) to ensure that the Office of the DoD Actuary works with the Office of the Assistant Secretary of Defense (Health Affairs) to complete the assessment of the MEPRS cost data, and that the most reliable (budget or cost) data available is used in determining the FY 1999 liability.
7. December 1998 - September 1999: USD(P&R) to assure the reasonable accuracy, reliability, and completeness of all data collected for use in determining the FY 1999 liability.
8. December 1998 - September 1999: USD(P&R) to ensure that the Office of the DoD Actuary, with assistance from the Office of the Assistant Secretary of Defense (Health Affairs), completes the sensitivity analysis to determine the extent to which the liability is sensitive to cost data, demographic data, and economic assumptions.